

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

AN ADJUSTMENT OF RATES OF THE)
KINGSTON-TERRILL WATER DISTRICT OF) CASE NO. 9542
MADISON COUNTY, KENTUCKY)

O R D E R

On March 31, 1986, Kingston-Terrill Water District ("Kingston-Terrill") filed its application seeking an increase in its rates for water service. The proposed rates would generate approximately \$115,366 on an annual basis, an increase of approximately 40 percent in the rates currently being charged.

As part of its endeavor to shorten and simplify the regulatory process for utilities the Commission chose to perform a limited financial audit of Kingston-Terrill's operations for the test period, calendar year 1985. Commission staff performed the audit on May 28, 1986, and a report was issued on July 17, 1986. Kingston-Terrill filed a written response to the staff audit report on August 7, 1986.

A hearing was held on August 20, 1986, in the Commission's offices in Frankfort, Kentucky. There were no intervenors in this matter.

This Order addresses the Commission's findings and determinations on issues presented and disclosed in the hearing and investigation of Kingston-Terrill's revenue requirements. The

Commission has granted rates and charges to produce an annual increase in revenues of \$65,220 herein.

REVENUES AND EXPENSES

Discussion

The staff audit report contained recommendations concerning the rate-making treatment of Kingston-Terrill's pro forma operating expenses. Kingston-Terrill, in its response to the staff audit report took exception to several of the staff's recommendations.

In its report the staff recommended that Kingston-Terrill's pro forma adjustments to its operation and maintenance expenses for an additional employee, rent for a storage building, additional truck maintenance and health insurance for its employees be denied because they pertained to assets that Kingston-Terrill proposed to purchase but had not shown evidence of need nor proven a positive impact upon operations to the benefit of its ratepayers. In addition, the staff recommended denial of an increase in depreciation expense of \$5,176 for the costs of radios, a truck, a computer, a leak detector, a copier, additional office equipment, a pump, a telephone answering machine, a tapping machine and a fire hydrant meter.

In its response to the audit report Kingston-Terrill stated that at the upcoming hearing it would provide support for the proposed adjustments. Kingston-Terrill presented witnesses at the hearing testifying to its various needs: presently, Kingston-Terrill's manager provides his truck for use in Kingston-Terrill's

business; Kingston-Terrill is understaffed and cannot provide adequate coverage for vacations and illnesses; Kingston-Terrill needs additional storage space; its employees need health insurance, and Kingston-Terrill needs several smaller items necessary for more efficient operation.

The Commission realizes that a truck, adequate staffing and storage facilities are essential to the operation of a water district. However, the question is not only one of need. Kingston-Terrill has not yet purchased the truck, paid rent for the storage building or hired a new employee. Its witness testified that it may be 6 months to 1 year before the truck is purchased and, therefore, it would be 6 months or longer before any expenses would be incurred. It is unfair for the current ratepayers to bear the costs associated with assets or expenses that have not been purchased or made; thus, the Commission must deny the proposed adjustments to operation and maintenance expenses at this time.

Health Insurance

Kingston-Terrill proposed to increase its operation and maintenance expense by \$4,800 for health insurance for its employees. The staff audit report recommended that this adjustment be denied on the basis of its being speculative and no positive benefit to the ratepayers was shown. In its response to the audit report, Kingston-Terrill stated that this employee benefit

was needed to attract and retain competent employees.¹ At the hearing, Kingston-Terrill provided estimates of the cost from one provider, The Kentucky Rural Water Association.² The Commission agrees that this benefit is necessary in order to retain competent employees. Health insurance is not a luxury or an extravagance. However, the Commission does feel that only the coverage for the employees should be paid for by the district and family coverage should be provided by the employee. The Commission, therefore, allows an increase of \$2,268 to Kingston-Terrill's operating expenses or a reduction of \$2,532 from Kingston-Terrill's original proposal.³

Depreciation Expense

Kingston-Terrill reported depreciation expense of \$38,511 for the test period. In addition, Kingston-Terrill proposed to increase its depreciation expense by \$5,175. The increase is proposed to amortize the cost of a group of assets that Kingston-Terrill wishes to purchase. Kingston-Terrill took issue with the staff's recommendation that the adjustments be denied; however, at the hearing, Kingston-Terrill's witness testified that the items would be purchased as the money became available and that it may be two or three months before enough money was available to purchase anything.⁴ The Commission cannot allow the ratepayers to

¹ Response of Kingston-Terrill to Staff Audit Report, page 3.

² Transcript of Evidence ("T.E."), page 57.

³ \$63 X 3 employees X 12 months = \$2,268.

⁴ T.E., page 56.

bear the costs in advance of the use or purchase of assets that Kingston-Terrill may purchase and, therefore, it is the Commission's judgment that Kingston-Terrill's proposed depreciation expense be reduced by \$5,176.

In addition, the Commission concurs with the staff that depreciation on contributed property be disallowed, thereby reducing Kingston-Terrill's depreciation expense by \$9,757.

REVENUE REQUIREMENTS

Kingston-Terrill proposed that it be allowed to earn a 5 percent return on its total assets. It is the Commission's opinion that a return of this amount would result in excessive earnings. Kingston-Terrill contended that in order for the district to maintain its financial integrity and keep it free from creditor control that a "cushion" in this amount is needed.⁵ Kingston-Terrill wishes to accumulate an amount of \$60,327 above and beyond its proposed operating expenses. While the Commission looks favorably upon a utility wanting to accumulate funds in order to meet emergencies, Kingston-Terrill must realize that accumulation of this amount will occur on an annual basis, not just for the first year that the rates would be in effect. Additional earnings of this amount result in an approximate 14.5 percent return on net investment and a 2.1X debt service coverage ("DSC"). The Commission considers a return of this magnitude to be excessive and rejects Kingston-Terrill's proposal for a 5 percent return on total assets.

⁵ Response of Kingston-Terrill to Staff Audit Report, page 6.

In its report, the Commission staff recommended a 1.2X DSC stating it would provide sufficient revenues to allow Kingston-Terrill to meet its operating expenses, cover its debt and provide for reasonable equity growth.⁶ The Commission concurs that a 1.2X DSC would allow Kingston-Terrill to service its debt and cover its operating expenses; however, it is the Commission's judgment that a 1.2X DSC will not allow Kingston-Terrill sufficient funds for growth and may not allow Kingston-Terrill to maintain its required reserves based on the level of expenses found reasonable in the staff report and the support provided for anticipated, but estimated expenses of the future.

Since 1981, Kingston-Terrill has experienced an average annual growth in investment of 13 percent. Kingston-Terrill has had to acquire additional debt as well as use its accumulated cash reserves in order to handle the growth. This has caused a gradual deterioration of Kingston-Terrill's cash position as well as its overall financial position. Although Kingston-Terrill has some cash reserves at present, it has potential current liabilities that could deplete the reserves at any moment in the form of a demand note. Additionally, Kingston-Terrill has stated the need for further expansion, but at present, does not have the funds available.⁷

⁶ Staff Audit Report, page 8.

⁷ T.E., page 100.

Thus, based on the above findings, it is the Commission's judgment that an operating ratio will provide Kingston-Terrill a revenue requirement which best provides an adequate cash flow to sustain its current and potential needs and finds an operating ratio of 88 percent most appropriate absent the allowance of many of Kingston-Terrill's proposed adjustments. Although the Commission has used a methodology other than the DSC in this case, it still finds it to be an adequate measure of a non-profit water system. However, it should be noted that, although certain specific adjustments were denied, this level of revenue should allow Kingston-Terrill the latitude to acquire in the next few years the majority of the items it proposed without undue hardship.

Thus, the Commission finds that Kingston-Terrill should be allowed to increase its rates in an amount sufficient to produce additional revenues of \$65,220 on an annual basis, calculated as follows:

Operating Expenses	\$ 324,558
+ .88	<u>368,816</u>
ADD:	
Interest Expense on Long-Term Debt	<u>39,435</u>
Total Revenue Requirement	\$ 408,251
LESS:	
Annualized Test Period Revenues	\$ <315,658>
Interest Income	<12,000>
Misc. Service Revenues	<u><15,373></u>
REQUIRED INCREASE TO RATES	<u>\$ 65,220</u>

SUMMARY

The Commission, after consideration of the application and evidence of record and being advised, is of the opinion and finds that:

1. The rates and charges proposed by Kingston-Terrill will produce revenues in excess of the level found reasonable herein and should be denied upon application of KRS 278.030.

2. The rates and charges in Appendix A are the fair, just and reasonable rates and charges to be charged by Kingston-Terrill in that they should produce revenues from water sales of \$390,878 and gross revenues of \$408,251.

IT IS THEREFORE ORDERED that:

1. The rates and charges proposed by Kingston-Terrill be and they hereby are denied.

2. The rates and charges in Appendix A be and they hereby are approved as the fair, just and reasonable rates and charges for water service rendered by Kingston-Terrill on and after the date of this Order.

3. Within 30 days from the date of this Order, Kingston-Terrill shall file with this Commission its revised tariff sheets setting out the rates approved herein.

Done at Frankfort, Kentucky, this 6th day of October, 1986.

PUBLIC SERVICE COMMISSION

Richard D. Wrenn
Chairman

R. L. [Signature]
Vice Chairman

Spencer H. Williams
Commissioner

ATTEST:

Executive Director

APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 9542 DATED 10/06/86

The following rates and charges are prescribed for the customers in the area served by Kingston-Terrill Water District. All other rates and charges not specifically mentioned herein shall remain the same as those in effect under authority of this Commission prior to the effective date of this Order.

<u>USAGE BLOCKS</u>	<u>RATES</u>
First 200 Cubic Feet	\$7.35 Minimum
Next 300 Cubic Feet	3.25 Per 100 Cubic Feet
Next 300 Cubic Feet	2.35 Per 100 Cubic Feet
Over 800 Cubic Feet	1.45 Per 100 Cubic Feet